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BEFORE THE ARIZONA CORPORATION COMMISSION

RENZ D. JENNINGS
CHAIRMAN
MARCIA WEEKS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	**DOCKET NO. U-0000-94-165**

NOTICE OF FILING

The Arizona Utility Investors Association hereby files the attached Response Memorandum as an informational filing in the above-captioned docket prior to the workshop on electric industry restructuring scheduled to be held August 12 at the Arizona Corporation Commision.

DATED THIS 7TH DAY OF AUGUST, 1996.

Walter W. Meek

WALTER W. MEEK, PRESIDENT

Original and ten (10) copies of the foregoing Memorandum filed this 7th day of August, 1996, with:

Docket Control
Arizona Corporation Commission
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Phoenix, AZ 85007

Copies of the foregoing Memorandum were hand-delivered this 7th day of August,1996, to:

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IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. U-00094165

RESPONSE MEMORANDUM

I. Introduction

On June 28, 1996, at least 28 participants in the above captioned proceeding, including the Arizona Utility Investors Association (AUIA), filed responses to a comprehensive set of questions framed by Commission Staff regarding competition and industry restructuring. Thereafter, the Staff circulated a summary of those responses and announced that a workshop would be held August 12, 1996, to consider two "composite rules" which it "synthesized" from the responses.

AUIA has reviewed all of the comments filed in response to the Staff request. Not surprisingly, the responses from certain consumer organizations and some commercial and industrial energy users (collectively, the Respondents) contain elements which are highly objectionable to AUIA because they are destructive of the legitimate interests of utility shareowners and bondholders. AUIA supports the concept of competition in the electric utility industry, but some of the positions presented by the Respondents can lead only toward protracted legal conflict and away from a rational approach to competition. In our view, the time to confront some of these positions is now, before we stumble into a "Simon Says" style of rulemaking.

It may be that the upcoming workshop is an appropriate forum for airing the participants' differences, but that seems unlikely, given the narrow scope of the workshop. Furthermore, AUIA is one organization, representing the only constituency with an equity interest in this issue, and is significantly outnumbered by the Respondents. Unlike the public agencies and large corporations involved in this proceeding, AUIA cannot stretch its resources to staff all of the workshop sessions planned by the Commission Staff.

Therefore, in order to put our cards on the table where they are visible to all participants, AUIA is filing this memorandum in the competition docket prior to the August 12 workshop.

II. Perspective

It is clear that several of the Respondents are prepared to dismiss the interests of utility investors as an economic nuisance -- a contusion that should be treated with the least expensive medicine available. There is virtually no recognition that utility shareowners and bondholders are real people who have invested some or all of their life savings in paying for the utility infrastructure which now serves Arizona.

For most of the last 40 years Arizona has been the first or second fastest growing state in the country. During that time the Respondent companies have had the ability to expand or shrink their businesses, alter technologies, open and close facilities or change locations without any concern for their energy requirements or any need to invest their capital in energy supplies. These companies also have attracted tens of thousands of employees and their families who have received energy service without question while they have contributed to a collective load profile that is one of the most difficult to serve and economically inefficient in the entire country.

This record of uninterrupted service results from the utilities' fulfillment of their legal *obligation to serve.* It has been accomplished through the investment of billions of dollars under the assurances provided by the *regulatory compact.* Yet, some of these Respondents dismiss these concepts as mere historical oddities which can now be reduced to footnotes and forgotten, along with the investments that were made on their behalf.

History is of little value to these Respondents because it doesn't serve their needs. It is irrelevant to them that today's electric industry is the product of a century of regulation which, in Arizona, is embedded firmly in the State Constitution. These Respondents are in continuous denial over the fact that utility investors have a right to rely on the terms of the regulatory compact to protect their investments. They also dismiss the fact that utilities generally have had to plan and build to meet the energy needs of the entire population many years ahead of that need.

Commercial and industrial users are no longer willing to accept regional differences insofar as they are reflected in energy prices. But utility systems are different precisely because they were developed and regulated to meet local and regional needs.

Some Respondents imply that utility investors should be penalized today because of decisions made long ago. They suggest that different choices for generation should have been made in past years, as if utilities were blessed with perfect vision and unlimited energy options. Hardly. When the Palo Verde and Coronado generating stations were planned in the early 1970s, natural gas was a prohibited power plant fuel. It was also expensive and there was no large scale electric generating technology utilizing natural gas.

Acceptable sites for coal generation disappeared quickly in the wake of the Environmental Protection Act. If a utility had a coal site that was grandfathered or would pass EPA muster, it had to use it or lose it. The other available choice was nuclear power. Clean air and safety requirements produced comparable construction estimates for nuclear and coal in the 1970s (at about $950 per installed kW). Both dictated large capacity to achieve economies of scale and handle load growth, and each choice required a planning, approval and construction cycle of nearly 10 years. These were not poor choices. They happened to be the only choices.

Supply decisions were not simply blessed by the Commission. They were often challenged, and utility investors have taken several hits in asset write-offs and disallowed expenses on the way to used-and-useful determinations. For example, a three-year prudence audit of Palo Verde cost the ratepayers about $8 million, but utility investors absorbed another $30 million in audit expenses and $50 million in write-downs.

AUIA's intention here is not to teach a history lesson. It is to state as clearly as possible our position that Arizona utility investors have a moral, ethical, legal and historical claim for recovery of the full value of their assets regardless of changes in the regulatory framework of the industry. Further, we contend that the State of Arizona has an unmitigated legal obligation to protect that value from loss due to official acts of the State.

It may be that utility investors in some jurisdictions, where the regulatory authority is less obvious and the record is less clear, will go quietly into the night while their assets are dissipated in the name of competition. That will not be the case in Arizona. AUIA respects the interests of other stakeholders and we hope they respect ours. We do not want to see the transition to competition bogged down in litigation. However, AUIA must defend the rights of utility investors and our bottom line is that it must be clear how their values will be protected before retail competition begins in Arizona.

III. Issues

A. Stranded Investment

Obviously, stranded investment (sometimes referred to as stranded cost) is a threshold issue for utility investors. It is just as obvious that most Respondents would like to obtain the perceived benefits of competition in the electric industry while avoiding any costs associated with stranded investment. Most of the proposals advanced by these Respondents regarding stranded investment are absolutely unacceptable to investors. To wit:

- The Arizona Association of Industries (AAI) has urged that a prudency investigation be undertaken as a condition for recovering stranded investment. Its "Coalition" response calls for an "equitable sharing" between investors and customers. AUIA's position is that prudency is a settled issue with regard to any cost or investment that is included in rate base. In addition, there is no justification, legal or otherwise, for utility investors to suffer any economic loss in order to benefit the Respondents.

• Among other Respondents, Enron rejects 100 percent recovery out of hand, claiming it is anti-competitive and that it doesn't motivate utilities to mitigate stranded investment.

Enron's opinion is only that. The response of those who own the assets or have a mortgage interest in them is this: Any permitted recovery below 100 percent is arbitrary, capricious and illegal. Refusing to allow full recovery of stranded cost is no different from forcing a utility to divest its assets, which is another Enron proposal that exceeds the authority of the State.

• Respondent Nordic Power asserts that the whole issue of stranded investment should be placed in a separate docket and set aside until some future time after a competitive market has taken hold. From an investor's point of view, this is an absurd suggestion: that we wait to claim our lost value until there is no one left to pay it except the State. As we have indicated previously, it is central to the stranded investment issue that it must be resolved fully before the utility franchise is dismembered.

• The Staff's approach to stranded investment in its Composite Rules is confusing. The chief difference between Rule A and B is the start date, and the obvious advantage to a later start (Rule A) is that it allows more time to mitigate stranded investment. Yet, the treatment of stranded investment in both "rules" is too vague to reach any conclusion about a preferred approach. It will be reviewed "on a case-by-case basis," but how will it be determined? Who will pay it? How will it be collected? When will it start? Elsewhere, the Staff's general rule provisions assert that rates would not be increased for customers who are not in the competitive market which would seem to preclude imposing a CTC on all customers during any phase-in.

It is obvious that participants in this docket are all over the map on stranded investment, and we haven't a clue as to the direction this inquiry is taking. AUIA cannot endorse any approach to rulemaking, however preliminary, that does not attempt to define and resolve this issue at the outset.

B. Timing

Here also there are major differences in the views of participants on when competition should begin on a limited basis and when full access for all customer classes might be achieved. The startup window ranges from early 1997 (RUCO) to early 2000 (AUIA), and the horizon for full access ranges from early 1998 (Nordic Power) to 2004 (APS).

Generally, the commercial and industrial Respondents argue that they will lose economic benefits if they are forced to wait for competition. Of course, these Respondents have done without these alleged benefits for about 100 years and during most of that time it was in their interest to be served by a regulated industry. It is hard to fathom that a few more years will make a significant difference in their fortunes.

AUIA has no crystal ball for choosing the perfect timetable for phasing competition, but we would like to make three points:

1. Time is the enemy of stranded investment.

A quick transition to open access will create stranded investment. Within reasonable limits, a longer transition gives utilities more opportunity to become competitive by lowering operating costs, reducing debt and amortizing regulatory assets. These actions reduce everyone's exposure to stranded costs, but they take time to produce results.

As a specific example, the Commission has allowed APS to internalize some $1.3 billion of regulatory assets on an accelerated eight-year amortization schedule which commenced July 1. That task won't be completed until 2004 and more than half of the starting amount will still be on the company's books in 2000 when RUCO wants to see full competition.* At any time prior to 2004, the balance of regulatory assets would have to be converted to a competitive transition charge or exit fees or both.

It is worth noting that electric cooperatives have no place to absorb stranded investment except through their customers who are also their owners in most cases. Likewise, Salt River Project has no refuge for stranded costs except its customer base.

2. A short transition threatens residential customers.

As we have stated, simple math dictates that the shorter the transition to open access, the greater the exposure to stranded investment. In a longer, phased transition, stranded costs would be reduced and it would also be feasible to compute and assess exit fees on large users who leave the utility system first and are most likely to achieve energy savings. A short transition requires a quick fix for stranded investment and virtually guarantees that the cost will be shared by the entire customer base, including residential customers who may never experience any significant savings.

Enron is so explicit that its proposal reads like the surrender terms delivered to a defeated army: Enron wants the Commission to invalidate existing contracts and require full divestiture by vertically integrated utilities. Enron also rejects exit fees and wants any competitive access charge to be levied against all customers.

Enron's position gives away its game. In fact, Enron spokespersons in other forums have warned the natural gas industry that electric restructuring must be accelerated or, God forbid, electric utilities will use the time to mend their structural problems and actually become more competitive.

3. Hasty restructuring may be foolish.

AUIA can see no advantage for Arizona in being one of the first states in the country to adopt retail competition. Apart from the obvious -- there may be no reciprocal opportunities for Arizona utilities in other jurisdictions -- restructuring should follow a sequence that allows Arizona to learn from regional and national developments and avoid costly mistakes.

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* The amortization will not take place on a linear basis because of the compound growth component in APS' projections.

For example, several pieces still need to fall into place in the California puzzle. FERC probably will be dealing with complaints and clarifying its open access rules well into 1997. The U.S. Congress now has restructuring on its radar screen and could take on a host of issues, ranging from state-federal jurisdiction to federal power marketing and stranded investment, but action is unlikely before late 1997 or 1998. Local restructuring can't be accomplished without action by the Legislature which is unlikely before 1998.

AUIA believes that a rush into rulemaking would be foolhardy while so many developments beyond Commission control are still unresolved.

C. Aggregation/Municipalization

Several Respondents emphasize the theory of customer aggregation as a means of advancing competition. To its credit, only Nordic Power has suggested that aggregation should make some kind of economic or marketing sense, as in contiguous designated service areas. Other respondents apparently would allow marketers to aggregate anybody or anything anywhere on the landscape.

AUIA doesn't propose to debate the economics of aggregation or the pitfalls of cost allocation in the aggregation theory. However, we will assert emphatically that aggregation cannot be used to circumvent investor rights by devaluing utility property or the utility franchise.

We are not only concerned about the theoretical disposition of uneconomic assets (classic stranded investment) but the fact that the utility system in its entirety was built to serve all customers. Arizona case law is clear that a utility's property and its customer base cannot be appropriated without compensation. Therefore, aggregation is unacceptable without a full resolution of compensation issues.

All aggregation proposals in this docket suffer from this deficiency, but RUCO's proposal to allow municipalities to aggregate residential customers without any compensation is utterly untenable, especially on a schedule that calls for full competition by Jan. 1, 2000. The RUCO scheme raises these issues:

- The aggregated population would become immediately responsible for its proportionate share of utility investment, stranded or otherwise.
- Many cities could not resist the opportunity to generate new revenue by skimming a percentage of utility charges. This would insert a new layer of government into the electric utility business.
- If municipalities could aggregate residential customers, there is no obvious reason why they couldn't also aggregate commercial and industrial customers. Carried to its fullest potential, this would simply transfer electric service to municipal government.
- Under the Arizona Constitution, municipalities are exempt from ACC regulation, so it is questionable whether the Commission could enforce the collection of competitive access charges or any other fees against municipal customers.

While aggregation may have a place in a competitive industry that is free of regulation, it has serious pitfalls for utility investors which cannot go unchallenged in a transition period.

D. Certificates of Convenience & Necessity

In its proposed rules, Commission Staff asserts that all sellers of electricity must obtain CC&Ns and follow Commission rules in a competitive market. AUIA supports this approach, but almost every one of the Respondents opposes the notion of continued regulation. They propose that electricity sellers should simply register with the State or obtain some kind of license.

Absent a convincing legal argument to the contrary, AUIA believes that the Commission cannot sidestep or abrogate its Constitutional mandate to regulate the sale of electricity unless and until the Arizona Constitution is amended by a vote of the people. However, apart from the legal issues (which we discuss separately below), there are other good reasons for the Commission to continue to regulate electricity sales. Two of them are:

1. Consumer Protection

When long distance calling was deregulated, it was not uncommon for a new long distance company to contract to provide service and then disappear overnight from the marketplace. A dozen years into deregulation, consumer abuses such as "slamming" not only continue but are on the increase.

It is an absolute certainty that abuses will occur when retail competition in electricity is introduced to the public, but the stakes will be much higher and the potential damage to consumers of every kind will be much greater. A residential customer who spends $180 a year on long distance calling may spend 10 times that much on electricity.

Recently, Moody's Investors Service reported that the vast majority of firms nationwide that are engaged in marketing, brokering and aggregating electric energy sales do not have adequate credit ratings to support their commitments and are unable to issue investment grade paper.

Consumers must have some place to turn for relief when they are wronged by unscrupulous or incompetent energy providers. A licensing or registration requirement will not provide the legal clout to protect consumers any more than it does today for those who are damaged by dishonest contractors, insurance agents or funeral directors.

The practical difference is that a bad deal on electricity could leave an old, sick person suffering in 115-degree summer heat or a small business owner unable to operate his or her business.

2. Investor Protection

As we have documented previously, there has been no resolution or even a clear direction in this proceeding on stranded investment and other compensation issues. AUIA can't even guess at this point how the economic interests of shareholders and bondholders will be protected. In these circumstances and for reasons which we will discuss below, AUIA cannot foreclose any protective device, including the regulation of those who intend to sell electricity in the exclusive service territories of electric utilities.

E. Unresolved Legal Issues

Early in these proceedings AUIA urged that a good faith attempt should be made to resolve or at least expose to debate a number of legal questions which have the potential of derailing competition through protracted litigation. It may be that some of these issues are too difficult to resolve without a trip to the courthouse, but an attempt should be made before the Commission or the Legislature goes too far with restructuring. Last year, a legal subcommittee of the Working Group met briefly but produced nothing of substance.

We are now moving into a discussion of proposed rules and AUIA feels compelled to renew its argument that certain threshold legal issues should be addressed. Some of the issues are as follows:

1. Exclusivity

Does the Commission or the Legislature have the authority to abrogate the terms of an exclusive CC&N by requiring or allowing retail competition within the utility's service territory?

The Arizona Supreme Court's ruling in *James P. Paul Water Co. v. Corporation Commission*, 137 Ariz. 426, 671 P.2d 404 (1983) is unequivocal in asserting that the CC&N confers an exclusive right to provide service as long as the holder can provide adequate service at a reasonable rate. It follows that the CC&N cannot be abrogated and the service franchise cannot be dismembered without the utility's consent.

2. Vested Property Right

Does the CC&N confer a property right on the holder, and is the utility entitled to compensation for losing its exclusive right to serve?

The Supreme Court's decision in *Paul Water Co.* strongly infers that the CC&N confers a property right upon the holder. It specifically declares that competition removes the reward that a public service corporation is entitled to for assuming the risks and obligations associated with certification. Under this construction, any incursion from retail competition in the absence of full compensation would violate the property rights of utility investors.

3. Stranded Investment

If Commission or Legislative enactments create stranded investment, can a utility and its shareholders be legally required to absorb any losses associated with that investment?

To do so would constitute an unlawful taking and would violate the property rights of the shareholders under the property provisions of the Arizona Constitution and provisions of the Fifth and Fourteenth Amendments to the United States Constitution.

Shareholders must be fully compensated for any expense or investment which was prudently made under a utility's obligation to serve and which becomes stranded due to a change in law or regulatory policy.

4. Obligation to Serve

If competition is allowed within a utility's certificated service area, can the Commission enforce the utility's obligation to serve within that area?

The obligation to serve exists only in the context of a regulated monopoly. When the regulatory compact unravels, so does the Commission's authority to compel service unless the utility agrees to a modification of its CC&N.

5. Required Regulation

Would an entity desiring to sell or wheel power to a customer in a host utility's exclusive service area have to submit to ACC jurisdiction as a public service corporation, and would its rates be regulated by the Commission?

A plain reading of Art. XV, Sec. 2 and Sec. 3 of the Arizona Constitution leads to the conclusion that no company can sell electricity to an end user in Arizona without submitting to Commission jurisdiction and that the Commission must set rates and charges. A contested decision could turn on the definition of a public service corporation (PSC) as discussed in *Southwest Gas Corp. v. Corporation Commission,* 818 P.2d 714 (Ariz. App. 1991). Most electricity providers, brokers, marketers and aggregators that we know of would qualify as PSCs under the court's criteria in *Southwest Gas.*

6. Regulating Customers

Can the Commission impose exit fees or wires charges on customers of electric utilities?

Most Respondents assume that programs such as DSM, renewable resources and low income subsidies can be funded broadly through "wires charges." Some Respondents, including AUIA, also assume that competitive access charges can be levied against the customer base through wires charges and that exit fees can be charged to departing customers as a condition of their release from the system.

While it is clear to us that the Constitution requires the Commission to regulate companies that sell electricity to end users in Arizona, we are not so sanguine about the Commission's authority to regulate those who buy electricity, especially outside the context of a regulated monopoly.

The Commission can dictate the price a utility charges its customers, but what happens when the user is no longer a utility customer? When the utility no longer provides the commodity? Or if there is no longer a utility to regulate? If a utility unbundles its services, the distribution company may become nothing more than a common carrier. We are unsure of the scope of Commission authority over common carriers and their customers.

IV. Summary

AUIA has an obligation to assert the interests of utility investors. We are not seeking to sidetrack this inquiry. However, we feel that the output from this docket will be more responsive to the needs of the Commission and all other stakeholders if we confront the key issues that separate the participants and grapple with some of the legal issues that may undermine competition. While there may be other acceptable mechanisms, AUIA believes that the appropriate procedure would be evidentiary hearings which result in factual and legal findings upon which the Commission can act.